

Active Management in Small Cap Equities — No Proof of Outperformance?

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I recently had a [conversation with Craig Lazzara](#), Head of Index Investment Strategy at S&P Dow Jones Indices, about his research on dispersion—a factor he believes is very important in explaining the opportunities for active managers. According to Craig, current dispersion readings are quite low, which implies there are fewer opportunities for active managers than usual. Since there generally is higher dispersion in small caps than in large caps, I thought it would be interesting to see how active managers had performed against broad indexes in the small-cap category over the past decade. Did the greater dispersion and increased opportunities for differentiation lead to better performance for active managers? Turns out it did not for the majority of the periods analyzed. **There Are Many Ways to Invest** There are numerous ways to invest, but the decision usually starts with whether to invest in either active mutual funds or passive exchange-traded funds (ETFs). Some argue that active managers are best suited to outperform, especially in small-capitalization stocks, because they think this area tends to be less efficient. Recently, as a result of the broad market rally, these same proponents of active managers have insisted that today's environment is ripe for active managers to outperform, so I want to take a hard look at the numbers. In the table below, I compare how some small-cap indexes have performed against U.S. ETFs and open-end mutual funds in the Morningstar Small-Cap Blend category.

Small-Cap Study (12/31/2003–12/31/2013)

Index	Average Annual Return			Calendar Year Return									
	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree SmallCap Earnings	18.32%	25.69%	N/A	45.37%	15.80%	-1.60%	26.60%	49.57%	-32.87%	N/A	N/A	N/A	N/A
S&P SmallCap 600	18.42%	21.37%	10.65%	41.31%	16.33%	1.02%	26.31%	25.57%	-31.07%	-0.30%	15.12%	7.68%	22.65%
Russell 2000	15.67%	20.08%	9.07%	38.82%	16.35%	-4.18%	26.86%	27.17%	-33.79%	-1.57%	18.37%	4.55%	18.33%
Did Managers Outperform the Specified Index?													
WisdomTree SmallCap Earnings	No	No	N/A	No	No	No	No	No	No	N/A	N/A	N/A	N/A
S&P SmallCap 600	No	No	No	No	No	No	No	Yes	No	No	Yes	No	No
Russell 2000	No	Yes	No	No	No	Yes	No	Yes	No	Yes	No	Yes	Yes
Percentage of Managers Beaten by the Specified Index													
	3 years	5 years	10 years	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
WisdomTree SmallCap Earnings	88.9%	96.4%	N/A	91.7%	58.0%	68.2%	60.8%	90.3%	65.3%	N/A	N/A	N/A	N/A
S&P SmallCap 600	89.6%	70.0%	86.3%	79.9%	66.6%	91.4%	57.3%	26.9%	78.9%	53.3%	45.9%	65.7%	81.6%
Russell 2000	54.8%	48.8%	56.3%	64.0%	67.8%	38.0%	63.1%	39.6%	57.0%	42.4%	78.1%	32.8%	46.5%
Number of Managers	678	654	504	722	735	731	718	706	666	643	604	572	545

Sources: WisdomTree, Zephyr StyleADVISOR, Morningstar; 12/31/2003–12/31/2013. Past performance is not indicative of future results. You cannot invest directly in an index.

- **Majority of Active Managers Underperform** – Over the most recent 10-year period the Russell 2000 Index and the [S&P SmallCap 600 Index](#) outperformed 56.3% and 86.3%, respectively, of managers in the Morningstar Small-Cap Blend category. The Russell 2000 also outperformed more than 50% of the Morningstar category in 5 out of the past 10 calendar years, and the S&P SmallCap 600 outperformed more than 50% of the category in 8 out of the past 10 calendar years. Notice the differentiation between the S&P Small Cap 600 and the Russell 2000. I discussed the benefits of including a profitability and quality screen in the S&P methodology in this research piece, and we can see its track record added considerable value by substantially increasing the percentage of active managers it beat.
- **WisdomTree SmallCap Earnings Index** – WTSEI has outperformed over 91% of the Morningstar category since its inception.¹ I find it impressive that the Index was able to outperform over 90% of the category during the 2009 and 2013 calendar years, which were some of the best-performing years for the category. It is even more impressive considering the Index also outperformed close to two-thirds of the category in 2008 and 2011, which were among the worst.

Why Indexes? Like all investors, active managers are susceptible to behavioral biases that can negatively affect their investment decisions. This is illustrated through the table above, which shows that the majority of active managers actually underperformed their respective benchmarks over the most recent 10-year period and over the majority of calendar years. For believers of active management, I think these results are even more alarming given the fact that the Russell and S&P indexes are market cap-weighted. Market cap-weighted indexes typically give the greatest weight to the stocks with the highest prices, without regard to any measure of fundamental value. As a result, the market capitalization-weighted index may tend to over-weight more expensive equities and under-weight those that may be relatively less expensive.

Why Smart Beta? Although I do not feel active management is necessary to provide compelling long-term returns, I do think it is important to invest with a disciplined focus on valuations. WisdomTree uses a rules-based methodology to weight the companies in its Indexes by their underlying fundamentals, such as dividends or earnings, because at WisdomTree we believe that stock markets are not always efficient. Furthermore, WisdomTree rebalances its Indexes annually to adjust for relative value. As I referenced above, although dispersion levels can't predict active manager performance, the current low dispersion levels imply that there are potentially fewer opportunities for active managers than usual. Given this reading and the historical underperformance of active managers against traditional indexes, I do not think it is time for active management within small-cap equities.

¹Sources: Zephyr StyleADVISOR, Morningstar; Index inception: 02/01/2007.

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